

### Developing regional financial markets – the case of East Asia

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# Developing regional financial markets – the case of East Asia

Michael Pomerleano

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## Abstract

The paper explores the extent and benefits of financial integration in East Asia. It presents evidence that the extent of financial integration in East Asia is less extensive than the aggregate data suggests. The paper then addresses why some countries are integrated more than others and discusses the obstacles to regional financial integration. The paper points out that East Asia's growth strategy has shaped bank centric financial systems. An important thesis presented in the paper is that reliance on bank-based intermediation has hindered financial integration. The prospects for regional financial integration would be improved greatly if governments would step back from the tradition of massive government involvement and allow market forces to play a greater role. The paper finally explores what can be done to improve the process of regional financial integration. A simple first step will be to harmonise the regulatory framework for non bank financial institutions.

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## Abbreviations

ABF	Asian Bond Fund
ACGA	Asian Corporate Governance Association
ASEAN	Association of South East Asian Nations
BIS	Bank for International Settlements
CMI	Chiang Mai Initiative
EMEAP	Executives' Meeting of East-Asia and Pacific Central Banks
EU	European Union
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
IMF	International Monetary Fund
MiFID	Markets in Financial Instruments Directive
ROSCs	Reports on the Observance of Standards and Codes



## 1 Introduction

In the late 1990s, the Asian crisis was a stark reminder of what happens when banking systems are weak. While the crisis had numerous causes, a major one was short-term capital flows, which contributed to currency and duration mismatches on the balance sheet of the banking and corporate sectors. Clearly the bank-centric financial systems in Indonesia, Korea, and Thailand paid a very high price: Indonesia's crisis in 1997–98 was one of the costliest in the world, and more than 50 % of Gross Domestic Product (GDP) was spent to bail out the banking sector. As is well known, the crisis was associated with major macroeconomic disruptions, including sharp increases in interest rates, large currency depreciations, output collapses, and lasting declines in the supply of credit. The collapse of the financial sector severely restricted growth, and the average income of Indonesians has yet to reach the levels before the crisis.

As a result of this experience, the policy community accords far greater importance to sound financial integration in economic development. According to a recent paper from the International Monetary Fund (IMF 2007), financial globalisation has increased dramatically over the past three decades, bringing numerous theoretical benefits. This trend has been particularly pronounced in advanced economies and more moderate in developing countries. The empirical benefits are evident in countries with well-developed domestic financial systems. However, the process of integration is nuanced, depending heavily on the existence of a strong financial sector and sound prudential policies. In light of the Asian crisis, it is not surprising to find that countries with a weak financial sector (particularly in banking) seem more likely to suffer crisis than countries that improved their prudential policies before liberalising the financial account. Financial integration leads to increased volatility in developing countries that lack robust financial systems and do not have a high degree of institutional quality. Similarly, countries need firm macro foundations. As expected, countries with current account deficits, rising inflation, and expansionary fiscal policies seem more likely to suffer a currency or debt crisis than countries with low current account deficits, low inflation, and solid public finances.

I am grateful to the organisers of this conference for giving me the opportunity to reflect on this issue. Given my operational experience during the Asian financial crisis, my interest in the topic is very pragmatic. This paper accepts the extent and benefits of financial integration and addresses two questions: *Why are some countries integrated more than others?* and *What can be done to improve the process of regional financial integration?* The term 'financial integration' as used in this paper applies to the *integration of financial markets* – that is, the extent of foreign investment in domestic financial markets and access to foreign financial products.

A distinction needs to be made between capital account liberalisation and convertibility, which refers to the freedom with which capital inflows and outflows of varying nature and maturities are allowed to move across borders. In fact, domestic deregulation, market opening, and capital account convertibility do not have to march in lockstep. A country does not have to lift restrictions on the capital account before deregulating its domestic financial markets and permitting foreign participation. In fact, there is considerable evidence (IMF 2007) that domestic financial systems can

benefit from foreign participation, and there is professional agreement that robust domestic financial systems are a precursor to opening up the capital account.

The paper is structured as follows. Section 2 briefly motivates the discussion by reviewing the need for and potential benefits of regional financial integration. Section 3 presents evidence on the extent of financial integration in East Asia. Section 4 discusses the obstacles to regional financial integration. In particular, it points out that East Asia's growth strategy has shaped countries' financial systems. An important thesis presented in the paper is that the East Asian growth model, in which policy makers "govern the market" by relying on bank-based intermediation, has hindered integration. The prospects for regional financial integration would be improved greatly if governments would step back from the tradition of massive government involvement and allow market forces to play a greater role. Section 5 discusses the preconditions for regional integration and offers recommendations to accelerate the integration process in East Asia. Further, based on the analysis of East Asian financial integration, it highlights policy implications for other regions. Section 6 concludes.

## **2 Motivation: the benefits of and need for regional financial integration in East Asia**

The macroeconomic arguments favouring financial integration are well known. Broadly speaking, financial globalisation should enhance international risk sharing, reduce macroeconomic volatility, and foster economic growth. First, financial integration implies that the allocation of capital is optimal, leading to improved economic efficiency. As argued in Feldstein / Horioka (1980), if financial integration is sufficiently advanced and capital is perfectly mobile, the correlation between domestic investment and savings should be low. International financial integration permits portfolio diversification: capital flows to the highest risk-adjusted returns and, in the process, risk-adjusted expected rates of return tend to equalise across countries.

Equally, as theory suggests and empirical evidence documents, financial integration brings intangible benefits. First, it leads to development of the domestic financial sector and facilitates the adoption of international best practices in accounting, financial regulation, and supervision. Foreign ownership of banks facilitates the transfer of credit assessment technology and risk management techniques. The issuance of external debt exposes countries to the scrutiny of credit-rating agencies and the market discipline of investors. Financial integration may improve policy discipline and signal a country's commitment to sound policies.

Recent evidence on the benefits of regional financial integration is presented in several studies. The Bank for International Settlements (BIS 2004; 2005) shows how foreign investment has brought efficiency and stability to emerging markets. An important benefit is the improvement in financial sector *efficiency* that arises from local banks' exposure to global competition. Generally, host countries benefit from the technology transfers and innovations in products and processes commonly associated with the entry of foreign banks. Foreign banks exert competitive pressures, bring demonstration effects, and transfer technology to local institutions, often in-

ducing them to improve their risk management, offer more competitive pricing, and allocate credit more efficiently. Foreign banks also help to achieve greater financial *stability* in host countries. Host countries may benefit immediately from foreign entry if foreign banks recapitalise weak domestic institutions and, in the process, provide needed balance-of-payments support. The better capitalisation and wider diversification of foreign banks, along with the provision of access to parent funding for local operations, may reduce the sensitivity of the host-country banking system to local business cycles and changing financial market conditions. The adoption of risk-based credit evaluation tends to reduce lending risks, and, in times of financial distress, a globally diversified bank has the headroom to recognise losses and resolve problems in a timely fashion.

In designing policy on the entry of foreign financial institutions, it is important to realise that multinational banks tend to emphasise lines of business that complement the services of local banks by following global clients into emerging markets. Pomerleano / Vojta (2001) examine the behaviour of the largest multinational or global banks. These institutions are capable of offering cutting-edge global platforms for wholesale services, generally at lower cost than purely domestic banks. Allowing global institutions to enter a market brings much greater competitive pressure on local banks to reach new domestic clients and thereby deepens the range of financial services available.

However, East Asia confronts the following paradox. Since 2002, official reserves in East Asia have grown at an unprecedented rate, mainly as a by-product of official efforts to resist currency appreciation. Those official reserves have been invested largely in low-yielding foreign assets. At the same time, private capital is flowing into the region from financial centres in Europe and the United States. While some of the outflows from East Asia are consistent with prudent portfolio diversification, outflows are sizeable, suggesting that East Asia does not have the capacity to intermediate financial flows. Therefore, East Asian financial intermediation is carried offshore. At the same time that East Asian savings are channelled abroad, there are vast unmet investment needs in the region. Among the major challenges facing East Asia are inadequate infrastructure (for example, transport and power) and lack of access to basic social services (for example, potable water, sanitation, education, and health care). Equally the explosive industrialisation has led to environmental degradation, which requires massive investments in environmental cleanup. The infrastructure needs in East Asia are estimated at approximately US\$ 200 billion annually over the next five years, or a total of US\$ 1 trillion according to the Asian Development Bank, the Japan Bank for International Cooperation, and the World Bank (2005). Much of this infrastructure financing will have to come from local and international capital markets.

Do local financial markets have the capacity to mobilise those resources? Table 1 presents the size of the domestic bond markets in select Asian countries. Local bond markets differ greatly in size, domestic institutional demand, liquidity, and supporting infrastructure. However, all of the bond markets in East Asian economies are dominated by government bonds and do not appear deep enough to handle the regional need for infrastructure. Equally, the range of instruments required for infrastructure financing appears inadequate. Securitisation – essential for infrastructure –

is still a frontier asset class, representing only 3 % (US\$ 120 billion) of the emerging fixed-income markets. Therefore, it is not likely that the domestic markets will be able to mobilise US\$ 1 trillion over the next five years. Meeting those financing needs will require far better-functioning local capital markets and non-bank financial institutions capable of intermediating those savings in the East Asian region. Supportive evidence comes from Sheng (2006a; 2006b), who argues that, despite the lessons of the Asian crisis and efforts to develop bond and equity markets, Asian financial systems remain bank-dominated, with fledgling bond markets, speculative stock markets, and small insurance and pension systems. Sheng's message is that, even though economic fundamentals and the resilience of Asian financial systems have improved, financial integration is proceeding slower than trade integration and regulatory and other barriers still hinder integration.

<b>Table 1: Total debt outstanding in selected Asian countries in 2005 (in billions of US dollars)</b>				
<b>Country</b>	<b>Total</b>	<b>International</b>	<b>Domestic public sector</b>	<b>Domestic private sector</b>
<b>Asia, larger economies</b>	<b>2,408</b>	<b>123</b>	<b>1,514</b>	<b>772</b>
China	936	17	636	283
India	237	9	223	6
Korea	969	75	499	395
Taiwan, China	266	21	157	87
<b>Other Asia</b>	<b>360</b>	<b>70</b>	<b>209</b>	<b>80</b>
Indonesia	61	7	48	7
Malaysia	136	24	55	56
Philippines	70	29	40	1
Thailand	93	11	66	16
<b>MEMO ITEM</b>	<b>35,992</b>	<b>8,367</b>	<b>9,289</b>	<b>18,335</b>
Sources: Committee on the Global Financial System, BIS ( <a href="http://www.bis.org/cgfs/index.htm">http://www.bis.org/cgfs/index.htm</a> )				
Memorandum item: Australia, Belgium, Canada, Germany, Hong Kong SAR, Singapore, Spain, United Kingdom, United States				

How can the gap between the savings available and the infrastructure investment needed be explained? A possible explanation is that the East Asian financial systems do not possess adequate local instruments to absorb and intermediate the high level of savings in East Asia. For example, Caballero (2006) argues that there is a shortage of financial assets in emerging markets. The supply in emerging markets is not keeping up with the wealth created and the demand for stores of value, and collateral. Therefore, the surplus savings are placed with U.S. and European financial intermediaries. Those savings are recycled back into East Asia in the form of foreign portfolio investment and foreign direct investment.

An apparent paradox in financial services is that, despite the fact that finance is abstract and deals with products and that the revolution in communications has made physical location irrelevant, financial firms continue to be spatially concentrated in the same regional financial centres (the City in London and Manhattan in New York) and even in the same blocks in those cities. This suggests that geography matters for financial firms. Why? Two arguments favour regional financial integration. First, recent empirical research provides ample evidence that information asymmetries appear to increase in distance. For example, in a recent paper (Rose / Spiegel 2007) find that remoteness from financial activity, as measured by the distance to major international financial centres, increases macroeconomic volatility. They explain it by information asymmetry – distance leads to opaqueness.

Second, research points out that a great deal of knowledge is created and transmitted in the context of communities of practice linked by common norms of communication and rules. An ‘epistemic culture’ is the term that researchers use to describe communities identified with the process of creating knowledge. Such work-based communities share common cognitive frames and rules governing the creation, validation, and selection of knowledge. Considerable research has been done on epistemic communities and the development of local knowledge. Several recent studies have shown that proximity among collaborators is positively associated with innovation among knowledge-intensive small firms (Gittelman 2003).

Similarly, the combination of several intertwined favourable factors – complementary products, epistemic local communities, and suitable regulation – create the critical mass for competitive financial centres. Similarly, the agglomerations of financial firms in a particular region are conducive to the development, accumulation, and preservation of local knowledge and lead to financial deepening. The physical presence of financial firms in the East Asian region is likely to provide a platform for the diffusion of skills and expertise and the exploitation of local knowledge that is not possible from afar. The previous discussion helps to clarify the benefits of regional and global integration. The local knowledge argument suggests that regional integration and global integration are complementary – regional integration brings the benefits of global integration locally. In this context, regional integration offers a venue through which to reach critical mass in meeting East Asia’s need for financial services **in East Asia**.

### **3 What is the present level of integration in East Asia?**

Several forces are leading to increasing financial integration. First, East Asia has emerged as a third area of trade integration, following the European Union (EU) and the North American Free Trade Agreement. Intra-Asian trade has risen from 34.6 to 54.5 % of the region’s total world trade over the last quarter century (Sheng 2006b). East Asian trade is driven by the manufacturing global supply chain. In this context, deeper regional financial integration is likely to follow trade integration. Second, domestic policies in East Asian economies have moved away from ‘governing the market’ to relying on market forces. Third, there is a paradigm shift from a bank-dominated to a market-based financial world. Finally, East Asian economies are be-

coming more affluent. All of these trends bode well for regional and global financial integration.

How is financial integration defined and measured? Quantifying the extent of financial integration is a multifaceted concept, usually referring to the size of gross stocks of external assets and liabilities, the potential for large net flows (that is, differences between savings and investment flows), and the absence of opportunities for arbitrage between returns on assets in different countries. The most widely accepted measure of financial integration, presented in Lane / Milesi-Ferretti (2006), is the extent to which countries are linked through cross-border financial holdings (measured by the sum of countries' gross external assets and liabilities relative to GDP). According to Mauro / Ostry (2007) financial globalisation, measured by gross external assets and liabilities relative to a country's GDP, has approximately tripled since the mid-1970s. High-income countries account for most of the increase. In low- and middle-income countries, average increases have been more moderate. Within this group, however, there is substantial variation. Countries in East Asia have, on average, experienced a sixfold increase. However, the measure has limitations. Gross external assets and liabilities relative to a country's GDP might not be indicative of private financial sector integration in Asia. In East Asia capital outflows are accounted for by the official sector's investment of reserves. These are primarily in long-term dollar- and euro-denominated assets and account for roughly 65 % of all capital outflows from the region. By contrast, private investors account for the majority of capital outflows from Europe and the United States.

Following on Feldstein / Horioka (1980), another measure of financial integration uses correlations between savings and investment to measure the degree of international financial integration for groups of countries in different historical periods. Finally, comparisons of prospective returns on financial instruments in different countries (for example, covered or uncovered interest parity) provide a natural gauge of the extent of international financial integration. These measures also have limitations, which are not discussed here.

What about financial integration in East Asia? Recent evidence is found in a paper by García-Herrero / Wooldridge (2007), which reviews the progress of global and regional integration in emerging markets. The quantitative data point to significant integration over the past decade. The authors find that new members of the European Union (EU) have reached a very high level of financial integration, comparable in some respects to that of more mature economies. García-Herrero and Wooldridge attribute the high level of regional integration in Europe to the common institutional and regulatory framework provided by the European Union, together with the motivation of joining the Euro Area. Regional financial integration in Latin American countries lags behind that in the new EU members. The situation in Asia is somewhere in-between that of Latin America and Europe. It should be noted as well that capital flows **within** the East Asian region remain surprisingly small, particularly in the context of growing trade links and integrated supply chains. Most cross-border holdings are distributed among the three big global financial centres: the United States, the United Kingdom, and the Euro Area. Equally the cross-border outflows of East Asian countries are official reserves, while the inflows are mainly private flows from those three centres.

Recent Bankscope quantitative data document the rapid entry of foreign firms into the financial sectors of emerging markets in the last few years, especially in banking. In Latin America, the foreign bank share of total assets rose from 34 % in 2001 to 38 % in 2006. In Eastern Europe, the foreign bank share rose from 48 % in 2001 to 72 % in 2006 (BIS 2006). In Asia – particularly in China and India – the foreign share of total assets lags behind (see Table 2).

<b>Table 2: Role of foreign banks</b>			
	Share of foreign banks in total assets (%)		Number of foreign banks, as % of total
<b>Country</b>	<b>2000 or 2001</b>	<b>2005 or 2006</b>	<b>2006</b>
China	2	7	10
Hong Kong	59	93	49
India	20	24	22
Indonesia	36	45	25
Korea	25	26	8
Malaysia	19	20	17
Philippines	35	50	28
Singapore	36	3	30
Taiwan, China	2	6	7
Thailand	22	26	20
Average			
Africa	52	64	45
Eastern Europe	53	72	45
Latin America	36	38	25
Source: Bankscope			
Note: Foreign banks: companies with ultimate owners of shareholders (owning together 51 %) located in another country (including subsidiaries within a country).			

Qualitative evidence regarding financial integration comes from a recent Bank for International Settlements (BIS) report (BIS 2006), which documents structural changes in emerging markets. Banking systems in emerging economies have been transformed by privatisation, consolidation, and foreign bank entry. More recently, reforms appear to have slowed, in part because the easy work has been done. For example, rather than engaging in full-scale privatisation, countries like China and India are only gradually transferring ownership of major state-owned banks to the private sector. Bank consolidation has been market driven, and foreign banks are playing an important role in Central and Eastern Europe and in Mexico, while the state is playing a larger role in Asia.

The papers in *Open Doors: Foreign Participation in Financial Systems* (Litan / Masson / Pomerleano 2001) provide corroborative evidence of the growing presence of foreign firms in key parts of the financial sectors in the developing world, although Asia and Africa lag significantly behind other emerging markets. The papers also document the important benefits that foreign firms bring to the markets they enter: added investment, cutting-edge technologies, better managerial practices (especially risk management), and, because they tend to be more diversified than local institutions, more financial stability. At the same time, the papers note that the globalisation of finance raises new policy issues that must be addressed, particularly in the coordination of regulation and supervision across national borders.

Recent papers point out that capital markets in East Asia are not important. The stock markets in Indonesia, the Philippines, and Thailand have modestly low absolute and relative market capitalisation (to GDP) and low capital mobilization and turnover. Weak legal protections for minority shareholders and limited development of institutional investors have limited the free float (percentage of shares owned by the public), and a large percentage of shares are closely held. For instance, in Indonesia, as in a number of East Asian countries, many of the companies are family-owned businesses that float only a small proportion of stock. They tend to be managed as family entities, raising concerns about the rights of minority shareholders. For the top 20 companies by market capitalization, the free float is only approximately 36.4 % (World Bank 2006). Pitsilis / Sheng / Twiss (2007) write that the independent exchanges of Southeast Asia, with their lower liquidity and subscale trading and clearing facilities, face a serious risk of being marginalised, with detrimental effects on capital market development. They write that, while stock markets can be expected to grow in most East Asian economies, their absolute size is bound to remain small relative to world or regional stock markets, inflicting competitive disadvantages. The lack of local competitiveness is encouraging stock market activity to migrate to international financial centres. The Balkanisation of Southeast Asia's exchanges stands in contrast to the global trends of consolidation. Pitsilis et al. attribute the lack of integration to conflicting national agendas and regulatory hurdles. They argue that policy makers should pursue long-term reforms and regional harmonisation efforts that would considerably enhance the long-term outlook for regional capital markets and their chance to remain credible fund-raising venues for the best companies in the Association of South East Asian Nations (ASEAN).

#### **4 What hinders financial integration in East Asia?**

One explanation points to the myriad regulatory restrictions that have stifled trade and investment in financial services. Several papers point to limited progress in World Trade Organization negotiations on freer cross-border trade and foreign entry in financial services. Sauvè / Steinfatt (2001) take a cautionary view of the progress of trade and investment in financial services. They find strong indications that trade agreements were used primarily to consolidate and "lock in" the status quo rather than to promote further market opening and stimulate the process of domestic regulatory reform. Considerable barriers to trade in financial services are embedded in domestic regulatory practices. Many countries maintain a multitude of trade and in-



vestment measures that hinder foreign participation under the guise of limiting systemic risk. Dobson (2002) cautions as well that the significance of the 1997 Financial Services Agreement should not be overstated. Dobson's paper discusses the apparent paradox between the long-term promise of financial sector reform and the reluctance of developing countries to open their financial markets: "*Neither the OECD countries ... nor developing countries ... made commitments amounting to much further market opening beyond the status quo.*" Schott (2008) expresses doubts regarding the prospects for multilateral trade agreements. There are many reasons why the Doha Round has progressed so slowly, but by and large Schott thinks that the fragmentation of players is leading to failure. The recent slowdown in the global economy does not bode well for prospective trade agreements.<sup>1</sup>

Others point to domestic regulatory and institutional weaknesses that hinder integration as well. Barton (2007) argues that the Asian financial system could become world class if its regulatory systems, economic ministries, and financial institutions would improve dramatically. The transition would be made easier if East Asia would develop as a more integrated financial market, with a degree of coordination and specialisation (for example, regional bond markets and consolidation of local exchanges).

However, the thesis presented in this paper is that the East Asian model of growth – predicated on 'governing the market' – is the *major* impediment to integration. How has the East Asian growth strategy shaped the East Asian financial systems? East Asia's financial system is a direct by-product of the East Asian development model. Wade (1990) persuasively argues that the predominant approach to economic policy in the 1950s and 1960s in East Asia stressed the links between corporations, banks, and governments and assigned a substantial role to the state in 'repairing' perceived market failures. East Asian policy makers distrusted market-based intermediation and based their countries' development models on a directed-credit approach of intermediating savings from the public through banks to businesses. The channelling of household savings by banks to corporates led to a bank-dominated financial system as opposed to a more market-based financial system. Therefore, domestic financial systems are bank based, and the participation of non-bank financial institutions in domestic systems is insignificant. Clinical evidence is offered in Hahm's (2005) discussion of the Korean banking system. The case study provides corroborative evidence for the directed-credit model. Korea's first major step toward financial liberalisation was to reprivatise commercial banks in 1981. While bank ownership was transferred to the private sector, government continued to intervene, both directly

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1 However, there is room for optimism that bilateral trade agreements can accelerate progress. The recent progress in financial services liberalisation via bilateral agreements undertaken by the United States is indicative of this potential. In bilateral trade agreements, the United States pursues comprehensive free trade agreements in financial services. The United States offers national treatment in financial services to the governments of emerging-market economies that provide reciprocal market access. Since 2004, the United States has completed and implemented 10 free trade agreements. The pending Korea-U.S. Free Trade Agreement is illustrative of other bilateral agreements.

(for example, through selective credit policies for heavy and chemical industries) and indirectly (for example, through controls over the allocation of bank credit), throughout the 1980s and early 1990s. Equally, the government continued to influence corporate investment decisions by controlling the governance of commercial banks. Prior to the crisis, the chief executive officers of publicly listed banks were appointed by the Ministry of Finance and Economy.

Therefore, the evidence suggests that bank-dominated systems are far more oriented to domestic growth strategies than market-based systems. Typically, domestic banks are well entrenched and reliant on long-term “name” relationships. Even leading banks in the region are domestically oriented and have not made headway in creating a broad-based regional financial institution. Singapore’s DBS Group Holdings is Southeast Asia’s largest banking group. DBS Bank’s stated goal in September 2000 was to become a world-class regional bank. However, the bank has not achieved its regional objectives, possibly due to nationalistic factors. Recently, Temasek said that, as a result of rising nationalism on sovereign-wealth investments, it would no longer seek controlling interests in companies outside Singapore (“Temasek, Reverse Charges,” *The Economist*, 2007). Similarly, Kookmin Bank, South Korea’s biggest lender, does not appear motivated by a regional strategy.

<b>Table 3: Financial system assets as % of GDP, 2000 and 2005</b>						
	<b>2000</b>			<b>2005</b>		
<b>Region</b>	<b>Deposit money banks’ assets</b>	<b>Equity market capitalisation</b>	<b>Total bonds</b>	<b>Deposit money bank’s assets</b>	<b>Equity market capitalisation</b>	<b>Total bonds</b>
Asia, larger economies	102	40	38	107	54	57
Other Asia	89	49	50	73	62	52
Latin America	42	34	50	41	45	60
Central Europe	39	20	34	46	31	52
Russia	22	15	17	30	72	9
Other	68	75	23	64	143	26
Developed countries	83	141	142	96	124	168
Sources: Datastream; IMF; Standard & Poor’s; World Bank; BIS						
Note: Deposit money banks’ assets refer (whenever available) to the claims on the private sector, non-financial public enterprises and central and local governments (lines 22a, 22b, 22c and 22d of the IMF’s International Financial Statistics). Total bonds include domestic money market instruments (table 2a of the CGFS questionnaire), domestic bonds and notes, and international bonds, notes, and money market instruments from the BIS database.						

Quantitative evidence documents as well that Asia’s financial system was and still is bank based. Table 3 desegregates the Asian financial system by bank credit to the private sector, stock market capitalisation, and total bonds outstanding. Total finan-

cial assets in Asia were about 202 % of GDP in 2005, while the level of financial assets in developed economies was 388 % of GDP that the same year. However, 44 % of Asia's financial assets were in the banking system. By comparison, banking assets accounted for only 25 % of total assets in the financial sector in developed economies. At the extreme, in Indonesia, the banking sector still controls nearly 72 % of financial assets. Supportive evidence is presented in Table 4. While in the United States the assets of other financial institutions are 249 % of deposit money bank assets, in Thailand they are only 23 %, and 10 % in the Philippines.

<b>Table 4: Other financial institution assets as % of deposit money bank assets</b>		
<b>Country</b>	<b>Region</b>	<b>Other financial institutions assets as % of deposit money bank assets</b>
Thailand	East Asia and Pacific	23
Philippines	East Asia and Pacific	10
Turkey	Europe and Central Asia	3
United States	High income	249
Netherlands	High income	85
Japan	High income	68
Canada	High income	46
Korea	High income	43
Singapore	High income	14
Mexico	Latin America and Caribbean	33
Chile	Latin America and Caribbean	23
Colombia	Latin America and Caribbean	18
Venezuela, RB	Latin America and Caribbean	3
Brazil	Latin America and Caribbean	2
Tunisia	Middle East and North Africa	24
South Africa	Sub-Saharan Africa	143
Source: World Bank, Financial Structure Dataset, 2006		

Sheng (2006a), who has been active in financial sector reform in East Asia for the past 30 years, argues that the lack of institutional development in East Asia's non-bank financial sector has led to inefficient intermediation and poor risk management. A more diversified financial sector would contribute to East Asian growth. The sector of non-bank financial institutions – notably, equity and bond markets, mutual funds, pension funds, insurance companies, and other institutions, such as venture capital and leasing companies – have important roles to play in the East Asian economies but are lagging behind. First, by ensuring contestability, a diversified financial system offers competition to the banking system, and non-bank financial institutions that compete with financial intermediaries can foster rapid market development. A wider range of financial products would benefit East Asia as well. The private sector needs different types of capital: risk capital from capital markets,

short-term financing from banks, as well as longer-term financing through capital markets and institutional investors.

Banks obtain most of their funding from deposits, and prudent asset-liability management says that banks should offer only short-term, floating-rate loans. Therefore, banks are not a source of long-term capital. Leasing and factoring services could help to provide term funding for the private sector, especially small and medium enterprises, which are often constrained by the lack of collateral. Private sector-led economic growth also requires well-functioning equity and corporate bond markets to serve as sources of risk capital. At present, the capital markets in East Asia (with the exception of China) do not mobilise adequate risk capital. The potential for growth of the equity markets in East Asia is significant, but decisive policies are needed to reach the full potential of the market. As previously discussed, East Asia is in dire need of infrastructure. Long-term bond markets could improve the intermediation between savings and investments, while providing long-term domestic financing for infrastructure. Institutional investors such as mutual funds, pension funds, and insurance companies are a critical source of demand for bonds. However, the base of institutional investors is small. For instance, the pension industry controls assets equal to less than 4.5 % of GDP in Indonesia and 8.4 % in Thailand, compared with Malaysia (57 %) and Australia (75 %). There is great potential to mobilise domestic resources through pension funds. The insurance sector has the potential to contribute to the long-term investment needs of East Asia; however, in East Asia the insurance sector is small as well. In Indonesia, for example, it constitutes just 4.3 % of GDP and is highly concentrated.

## 5 How to facilitate regional financial integration?

What measures are warranted to motivate and facilitate more rapid financial integration? De Brouwer (1999) discusses different methods for assessing the openness of a country's financial system to domestic and international influences and applies these tests to 10 countries in East Asia. He suggests that East Asia should adopt a phased approach to regional integration, with some of the more developed markets like Australia, Hong Kong, Japan, and Singapore working to attain free trade in services in the financial area first. In other words, East Asia should strive for a gradual process that first pursues cooperation and only then considers integration.

Sheng (2002) offers a complementary approach, firmly rooted in institutional economics: *“If we want to be part of the global market, one has to play by global rules and standards. This is the biggest lesson from Africa and Latin America.”* Global rules and standards are basically like a common language. After the Asian crisis, countries in the region suffered from myriad weaknesses in institutional infrastructure, including poor regulation as well as inadequate corporate governance, weak auditing and accounting standards, and inadequate bankruptcy law. For instance, Barth / Caprio / Levine (2006) argue that developing countries need to place far more emphasis on policies, such as disclosure requirements, that promote market discipline. East Asian countries have undertaken a range of remedial measures to establish sound foundations for financial markets, such as an improved regulatory framework and enhanced supervision. Clearly, adequate infrastructure – standards

and codes, complemented by a robust regulatory framework – is needed to improve the functioning of financial systems. Therefore, it is important to examine the progress that East Asian countries have made in adopting international standards and codes. One way to measure progress is to assess the convergence of countries to the ‘international highway’ developed by the international financial community. The standards and codes initiative was launched in 1999 by the Financial Stability Forum to strengthen the international financial architecture. The initiative covers 12 areas and associated standards, which are recognised as essential to financial stability. These standards relate to policy transparency, financial sector regulation and supervision, and market integrity (see Table 5). Reports on the Observance of Standards and Codes (ROSCs) covering financial sector standards are prepared under the International Monetary Fund and World Bank Financial Sector Assessment Program (FSAP). The FSAP seeks to identify the strengths and vulnerabilities of a country’s financial system, to determine how key sources of risk are being managed, to ascertain the sector’s developmental needs, and to prioritise policy responses.

<b>Table 5: Critical Standards and Codes designed by the Financial Stability Forum</b>		
<b>Macroeconomic policy and data transparency</b>	<b>Institutional and market infrastructure</b>	<b>Financial regulation and supervision</b>
Data dissemination Monetary policy transparency Fiscal policy transparency	Insolvency Accounting Corporate governance Auditing Money laundering Payment and settlement systems	Banking supervision Securities regulation Insurance supervision
Source: Financial Stability Forum ( <a href="http://www.fsforum.org/cos/key_standards.htm">http://www.fsforum.org/cos/key_standards.htm</a> )		

It is noteworthy that East Asian countries have not been particularly engaged in the FSAP. Countries such as China, Indonesia, Malaysia, and Thailand, while systemically important, have not been assessed (see Table 6). This information by itself might suggest that there is room for greater transparency in East Asia. Nevertheless, the findings from other FSAPs are instructive: in many developing countries (and this is not unique to East Asia), the underdevelopment of sectors such as securities markets, insurance, and contractual savings restricts the types of financial services offered (IMF / World Bank 2005).

How much progress have East Asian countries made in adhering to the international standards and codes? The ROSCs are published only occasionally at the request of the member country. Therefore, we have to rely on information in the public domain. eStandards has been monitoring countries’ progress in adopting and implementing international standards and codes established by the global standard-setting authorities. The compliance assessments rely exclusively on publicly available information, and the scores in each area and the averages are updated monthly as a result of a constant review of developments within each country. It is instructive to review the results, subject to the usual caveat. Those quantitative scores are, by their

nature, subjective and mask vast qualitative differences; moreover, information in the public domain is limited as well as of short duration. Having said that, using the average score across the 12 areas, representative countries selected for the sample made progress during the period (see Table 7). China, the Philippines, and Thailand improved their average score the most. Malaysia achieved modest improvement. Some countries (Hong Kong, Korea, and Singapore) even regressed, ending with a score lower than the maximum score achieved during the period. In reviewing the individual categories, the scores for macroeconomic fundamentals were relatively high to begin with and improved further during the period for all countries, especially in the area of data dissemination. The scores for institutional and market infrastructure were lower than those for macroeconomic fundamentals in all countries. In financial regulation and supervision, progress was uneven among and within countries. The findings are not surprising: first, efforts to address macro stability practices are the foundation for all other efforts, and second, micro institutional changes are far more dependent on institutional capacity and skills that are in short supply. Therefore, progress in areas such as financial regulation and supervision and institutional infrastructure is lagging.

<b>Table 6: Assessed countries</b>			
Argentina	Egypt	Jordan	Pakistan
Armenia	Estonia	Kazakhstan	<b>Philippines</b>
Australia	Finland	Kenya	Poland
Austria	France	<b>Korea</b>	Romania
The Bahamas	Georgia	Kuwait	Russian Federation
Bahrain	Germany	Labuan (Malaysia)	Senegal
Bangladesh	Ghana	Latvia	<b>Singapore</b>
Barbados	Gibraltar	Liechtenstein	Slovak Republic
Belgium	Greece	Lithuania	Slovenia
Bermuda	Guernsey	Luxembourg	South Africa
Brazil	<b>Hong Kong</b>	Malta	Spain
British Virgin Islands	Hungary	Mexico	Sri Lanka
Bulgaria	Iceland	Monaco	Sweden
Canada	India	Morocco	Switzerland
Cayman Islands	Ireland	Netherlands	Tunisia
Chile	Isle of Man	Nigeria	Ukraine
Colombia	Israel	New Zealand	United Kingdom
Croatia	<b>Japan</b>	Oman	
Czech Republic	Jersey	Panama	
Source: IMF / World Bank (2005)			

<b>Table 7: Compliance with Standards and Codes</b>					
<b>Country</b>	<b>Starting score 1-Jan-03</b>	<b>1-Dec-05</b>	<b>1-Dec-07</b>	<b>% improvement</b>	<b>Country ranking</b>
United Kingdom	73	84	78	6 %	1
China	15	22	23	56 %	64
Hong Kong	68	69	62	-10 %	15
Indonesia	28	39	41	44 %	46
Korea	31	63	46	49 %	42
Malaysia	37	38	45	23 %	43
Philippines	21	57	58	180 %	31
Singapore	38	63	56	49 %	29
Thailand	28	47	43	50 %	45
Argentina	43	53	38	-12 %	51
Brazil	30	51	39	31 %	48
Chile	38	62	53	40 %	31
Colombia	26	40	40	55 %	47
Mexico	43	57	45	4 %	43
Poland	54	58	63	17 %	13
Russia	36	50	48	33 %	41
Turkey	33	49	38	15 %	49
Source: eStandards ( <a href="http://www.estandardsforum.com/jhtml/ca/">http://www.estandardsforum.com/jhtml/ca/</a> )					

A vast literature finds that countries with better legal regimes have deeper financial systems (La Porta et al. 1998). Equally, improving the quality, comparability, and transparency of financial information is crucial for facilitating the operation of internal markets as well as for strengthening the economic links between countries. Information indicative of inadequate transparency comes from several sources. Drawing from the World Bank's Doing Business database (2005), Claessens / Tzioumis (2006) provide country rankings in a *credit information index*. This index measures rules affecting the scope, access, and quality of credit information. It ranges from 6 to 0, with higher values representing better institutional environment. The rankings are presented in Table 8. As can be seen, Malaysia is on a par with Canada, Japan, and the United States, while the Philippines ranks last at 2. The findings indicate that there is considerable room for improvement.

<b>Table 8: Credit information index</b>	
<b>Country</b>	<b>Index</b>
Canada	6
Japan	6
United States	6
Malaysia	6
Hong Kong, China	5
Taiwan, China	5
Pakistan	4
Singapore	4
Thailand	4
China	3
Indonesia	3
India	2
Philippines	2
Source: Claessens / Tzioumis (2006)	

Complementary evidence regarding governance and transparency comes from the Asian Corporate Governance Association (ACGA). The linkages between corporate governance and financial disclosure policies are well known. Strong corporate governance can serve to support credible financial disclosure. ACGA has designed a system for rating+ countries on their corporate governance<sup>2</sup>. The findings from the “CG Watch 2007” report (ACGA 2007) are not encouraging. The pace of reform has slackened (see Table 9), raising a warning flag that economic successes are fostering complacency. The report speculates that political paralysis (for example, Korea) or upheaval (for example, Thailand) has slowed the pace of reforms. The report documents regional improvements in auditing standards and practices but notes that accounting and auditing standards and practices lag international norms more than expected in many Asian markets.

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2 A detailed survey of about 80 questions assesses the extent to which markets are meeting international standards of corporate governance in five categories: rules and regulations (15 %), enforcement (both by the market and by the regulators, 25 %), political and regulatory environment (20 %), international accounting and auditing standards (20 %), and corporate governance culture (20 %). It covers not only the practices on paper but also their implementation. Each question receives an answer of yes, no, somewhat, or marginally, with a score of one point, zero, half a point, or a quarter of a point, respectively, for each answer. The score of each category is a simple average of all answers to the questions in that category; the total score for a country is a weighted average score over five categories.



<b>Table 9: Accounting/auditing IGAAP, 2003–07</b>				
<b>Country</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2007</b>
Singapore	90	95	95	88
Hong Kong	90	90	91	83
India	75	75	75	75
Japan	—	—	—	72
Taiwan	70	70	59	70
Korea	70	80	82	68
Malaysia	70	90	75	78
Thailand	60	85	73	70
China	50	75	68	73
Philippines	60	85	82	75
Indonesia	50	60	68	65
Source: ACGA (2007)				
— Not available				

As previously discussed, adherence to standards and codes needs to be complemented by a sound legal regulatory framework. As noted by García-Herrero / Wooldridge (2007), the new members of the EU come closest to achieving an integrated market. A possible explanation for their rapid integration is the common institutional and regulatory framework provided through EU directives, together with the desire to join the Euro Area. The push toward a single market in services in the EU focuses on harmonising wholesale financial services, such as inter-bank payment systems, and on areas in which benefits could be won fairly quickly, such as government bond and equity markets. Both factors have resulted in extensive cross-border financial ties. For instance, the key EU investment services directive sets conditions for a single EU-wide license for investment firms, which empowers stock exchanges to operate across borders. In November 2007 the EU introduced the Markets in Financial Instruments Directive (MiFID). The MiFID aims to reshape the financial markets in Europe by creating a common market for share, commodities, and derivatives trading across 30 countries in Europe. MiFID's objectives – increased transparency and reduced costs for the users of financial instruments such as equities, bonds, and derivatives – will be pursued through standardised rules on the dissemination of quotes, on pre- and post-trade transparency, as well as on “best execution” practices. The new rules end the monopoly of national stock exchanges over the trading of shares and open the field to newer electronic exchanges. As a result, the traditional business model of established exchanges is going to be challenged as never before. Such European initiatives give an example of how to push for greater financial integration in East Asia.

There is evidence of progress in improving the regulatory framework in East Asian countries, reflected as well in the progress made by East Asian banks in addressing their past vulnerabilities. Turner (2006) reports that the Asian crisis stimulated major

structural changes in the banking systems in some countries, and there is good evidence of stronger performance. Despite the improvements, he concludes that there are still several signs of inefficiency and poor risk management practices.

However, there is equal evidence that East Asian countries are lagging in the development of an effective regulatory regime for non-bank financial institutions. For instance, Carvajal / Elliott (2007) use the evidence from the FSAPs to assess securities regulatory systems, examine problem areas, and explore regional trends. They find that a consistent theme emerges regarding the inability of regulators in many countries to enforce compliance with existing rules and regulations. A combination of factors, including lack of power and authority, lack of resources and skills, and lack of political will, have undermined the regulators' ability to regulate effectively.

How much progress have East Asian countries made in the regulatory framework and regional cooperation? While the desire for cooperation is evident, regional cooperation in East Asia is narrow. In May 2000, the finance ministers of ASEAN+3 countries reached agreement on the Chiang Mai Initiative (CMI), which was the first significant regional financing arrangement that enabled countries to cope with disruptive capital flows and maintain stable exchange rates. Under the CMI, member banks are allowed to swap their own currencies for major international currencies for a period of up to six months. The CMI was designed to expand the existing ASEAN Swap Arrangement, by extending its coverage to all members of ASEAN and increasing the size of the swap arrangements, and to create a network of bilateral swap agreements between the countries of ASEAN+3.

The Asian Bond Funds is another notable initiative. The EMEAP (Executives' Meeting of East-Asia and Pacific Central Banks) Group, comprising 11 central banks and monetary authorities in the East Asia and Pacific region, launched two Asian Bond Funds (ABF1 and ABF2). The Asian Bond Funds are important steps in fostering regional cooperation in Asia. ABF1 invests in U.S. dollar-denominated bonds issued by sovereign and quasi-sovereign issuers in EMEAP economies. The ABF2 invests in domestic currency bonds issued by sovereign and quasi-sovereign issuers in the eight EMEAP markets. The initiative facilitates the reinvestment of a small portion of East Asia's reserves back into the region, while at the same time catalysing the development of regional capital markets. A primary objective of the ABF2 is to harmonise market practices and drive regulatory reforms leading to regional convergence. Harmonisation in domestic markets benefits all issuers and investors in the region. For example, at the regional level, EMEAP economies are currently reviewing or changing their tax and regulatory regimes to facilitate cross-border investment. At the domestic level, some economies are actively developing the relevant regulations to permit exchange-traded bond funds, which are innovative products targeting retail and institutional investors. Nevertheless, regional cooperative efforts clearly need to redouble.

In the introduction to the paper I stated that section 5 will highlight policy implications for other regions based on the analysis of East Asian financial integration. At the risk of repeating the obvious, the most important conclusion is not surprising: regional financial integration starts at home with reforms designed to strengthen the infrastructure of the financial sector and harmonise regulatory frameworks. Such

efforts can be complemented in Africa and Latin American with regional initiatives such as EMEAP's Asia Bond Fund initiative. In fact in my discussions with policy makers in the respective regions, there was considerable interest in such initiatives. Still, as important such initiatives are, the focus has to be put the domestic financial system in order.

## 6 Conclusions

This paper has presented evidence that East Asia needs to focus its efforts in several areas. The lesson from the Asian crisis and the recent subprime crisis in the United States is that systemic risks need to be addressed at home. In this context, domestic reforms will yield the greatest returns. *Domestic reforms* are the most promising venue to accelerate regional financial integration. What are the priorities? Foremost, there is a need for a change in mind-set. The process of regional financial integration would be greatly improved if governments would step back from the tradition of government involvement in bank-based systems and allow market forces and non-bank financial institutions to play a far greater role. Structural financial reforms need to remain front and centre on the policy agenda. Regional governments need to reduce state ownership, build solid infrastructure, and improve the information infrastructure and technology to reduce intermediation costs, provide limited safety nets, and use incentives to induce better market monitoring. In short, the big changes still have to come within the East Asian countries themselves.

Financial integration benefits from sound domestic financial systems, and governments need to strengthen the clout of supervisors. Improving the regulation of non-bank financial institutions is important. For that, East Asian financial policy makers need to redouble the efforts to develop the *non-bank financial institutions* sector within a sound and coherent regulatory regime. While banking regulation and supervision have improved throughout the region, added attention needs to be paid to the regulatory and supervisory framework for non-bank financial institutions. Equally, East Asian countries need to make substantial progress in institutional development along the lines prescribed by the *international standards and codes*.

In parallel, regional regulators should seek to improve cooperation between national regulators and adopt common standards in more areas, such as disclosure, governance, and insolvency. The authorities need to improve the acceptance of international standards and liberalise foreign entry into the domestic financial sector through foreign direct investment and financial services. Equally, national regulators ought to be more transparent with one another and share best practices. For example, modest steps toward regional cooperation could be undertaken under the auspices of regional bodies, such as the Asia-Pacific Regional Committee of the International Organization of Securities Commissions. East Asia could start with modest steps: harmonisation efforts could include consistent and modern listing requirements for the regional exchanges and a single prospectus for issuers (single “passport”) for stock markets. In the future, East Asia could consider reaching an agreement along the lines of the key EU investment services directive, which sets conditions for a single EU-wide license for investment firms and empowers stock exchanges to operate across borders.

Finally, skills are an often neglected dimension at the root of financial capacity. Finance is basically an abstract activity that requires considerable training. It is reasonable to postulate that skilled labour is by far the most important binding constraint in finance. Andrew Sheng (2002) posits that the financial sector in East Asia needs to think about the five “Ps”, the first of which refers to *people skills*<sup>3</sup>. Walter Wriston, a former chairman of Citibank, used to say that Citibank’s assets go up in the elevator in the morning and down at night. It is worth pursuing the logic further by asking: *What is at the core of financial institutions and the system of law and order?* They require considerable economic and financial expertise. A similar argument applies to law and order. Effective courts and out-of-court alternative dispute resolution systems require extensive legal expertise.

<b>Table 10: Number of certified public accountants (CPAs) per million</b>		
<b>Country</b>	<b>Number of CPAs</b>	<b>Number of CPAs per million population</b>
New Zealand	21.737	6.577
Australia	110.488	6.571
Canada	139.057	5.463
Singapore	12.465	4.709
Hong Kong, China	22.839	3.490
United States	351.611	1.438
Malaysia	23.168	1.081
Korea	7.169	156
Taiwan, China	2.300	124
India	110.256	123
Japan	14.235	115
China	61.255	54
Indonesia	7.985	40
Source: International Federation of Accountants survey		

A basic financial reporting framework requires financial reporting and auditing rules consistent with international norms. Achieving high-quality financial reporting also requires adequate availability of trained and experienced accountants and auditors. The financial reporting and auditing requirements need to be supported by parallel institutional and professional capacity to ensure credible financial reporting. The absence of professional skills leads to opaque and unreliable financial reporting. As the data in Table 10 show, there is a considerable shortage of chartered or certified public accountants in East Asia. Only isolated countries, such as Hong Kong and Singa-

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3 The other “Ps” are *pricing* of spreads that reflects the risk, the right *products* for better risk management, common *platforms*, and, finally, *political will*.

pore as well as Malaysia, possess the vast pool of trained financial professionals. In this regard, the United States has almost 352,000 certified or chartered public accountants, while China has only 61,000. Similar data provide evidence of an acute shortage of financial sector skills in the actuarial, appraisal, insolvency, financial analysis and legal professions.<sup>4</sup> East Asian countries could alleviate some, but not all, of the shortage of skills by supporting liberalisation of the movement of labour in the financial sector.

In conclusion, regional financial integration in East Asia offers enormous promise for the region. It has the potential to contribute to financial stability by reducing external vulnerabilities as well as deepen the financial system and contribute to infrastructure finance – a must for East Asia.

It should be noted, however, that regional integration need not and should not stand in contrast with integration into global financial markets. The two go hand in hand and offer complementary benefits. Regional financial integration is designed to overcome information asymmetries that increase in distance. Global financial integration, on the other hand, offers global platforms for transfer of resources to regions where they are needed.

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4 The data for appraisers, actuaries, chartered financial analysts, lawyers, and insolvency experts, while not presented here, are consistent with the data for accountants.



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